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No. 88-1789

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

H.J. FREEDE AND JOSEPHINE W. FREEDE,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition For Writ Of Certiorari To The United States Court of Appeals For The Tenth Circuit

Brief *Amicus Curiae* of the American Petroleum Institute

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QUESTION PRESENTED

Whether amounts paid under a take-or-pay contract by a natural gas purchaser constitute "production payments" within the meaning of Section 636(a) of the Internal Revenue Code?

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BRIEF *AMICUS CURIAE* OF THE AMERICAN PETROLEUM INSTITUTE

INTEREST OF THE AMICUS CURIAE

The American Petroleum Institute ("API") submits this brief with the consent of the parties as *amicus curiae* in support of the petition for writ of certiorari in No. 88-1789. The petition seeks review of a judgment of the United States Court of Appeals for the Tenth Circuit. *H.J. Freede v. Commissioner of Internal Revenue*, 864 F.2d 671 (10th Cir. 1988). That court reversed the decision of the United States Tax Court which ruled in favor of the taxpayer-petitioners, holding that payments received under a take-or-pay

natural gas supply contract constituted "production payments" under § 636 of the Internal Revenue Code, to be treated as nontaxable loans rather than ordinary income when they were received. *Freede v. Commissioner*, 86 T.C. 340 (1986).

In this case, the Internal Revenue Service ("IRS") contends that take-or-pay payments made to petitioners by Oklahoma Gas & Electric ("OG & E") are includable in petitioners' income in the year received. Petitioners argue that these payments constitute "production payments" under I.R.C. § 636(a) and thus are treated as mortgage loans for federal income tax purposes. API supports the petitioners' position that a producer who receives a take-or-pay payment realizes income from the sale of gas, not in the year in which the payment is received, but only in the year in which make-up production of gas occurs, *i.e.*, the year in which the purchaser recoups its loan through the purchase of the make-up gas under the take-or-pay contract or when the recoupment period expires. Take-or-pay payments are economically equivalent to a loan from the purchaser to the producer to be repaid with production. Thus, take-or-pay payments, like the proceeds of any other loan, do not constitute income when received by the producer. API is confident that plenary review by this Court would rectify the errors made by the Tenth Circuit in the decision below, precluding an inevitable conflict between the circuit courts and resolving properly the tax treatment of take-or-pay payments. This case presents an opportunity for this Court to further clarify the statutory meaning of a "production payment," a fundamental concept of mineral taxation which, in the

context of take-or-pay contracts, will resolve the proper tax treatment of billions of dollars.

API is a national trade association with over 200 company members which represents all facets of the petroleum industry: exploration, production, transportation, refining, and marketing. The vital interest of API's members in this case is that of taxpayers who are similarly situated to the petitioners in this case. Members of API include producers of natural gas who are parties to gas purchase contracts with take-or-pay provisions similar to the provisions involved in this case. API routinely participates on the petroleum industry's behalf in legislative, administrative, and judicial proceedings when issues of national significance are presented. This case presents such an issue.

REASONS FOR GRANTING THE WRIT

I. The Magnitude of This Issue And Its Recurrence Throughout The Natural Gas Industry Makes Imperative This Court's Review.

According to the Interstate Natural Gas Association of America (INGAA), from 1982-1987, interstate natural gas pipelines have incurred take-or-pay exposure of $21.8 billion.[1] Consequently, purchasers have made and will continue to make enormous payments to gas producers pursuant to take-or-pay contracts that are no different from that presented in the case at bar. In fact, the take-or-pay provision in the contract between petitioner and OG & E is typical of those commonly used in the industry throughout the 1970's and early 1980's. These clauses were standard provisions

[1] *See*, "A Comparison of the INGAA and NGSA 1988 Take-or-Pay Analyses," INGAA, 88-6, May 1988, p. 5, Table 2.

in virtually all gas purchase contracts between producers and purchasers entered into during that time. The use of these provisions grew out of the regulatory environment which has governed the natural gas industry until just recently. This regulation of the industry created artificial shortages of gas; in response to these shortages, take-or-pay provisions were uniformly negotiated as the *quid pro quo* for the producers' exclusive commitment of gas reserves to a purchaser. The partial deregulation of natural gas in the 1980's has produced a market where gas has been plentiful and gas purchasers have incurred enormous take-or-pay obligations as a result.

Take-or-pay provisions have historically been viewed as providing benefits to both natural gas producers and purchasers. Producers were benefitted by the assured cash flow provided by these clauses which enabled both large and small producers to finance the large initial expenditures needed to develop gas properties and also to bear the steady operating costs associated with producing gas. Without an assured cash flow for their product, many producers would have been financially unable to develop their gas properties. From the standpoint of the gas purchasers, these take-or-pay provisions insured them a supply of gas in a market where gas was in short supply.

Many court rulings, including dicta from this Court, have acknowledged the essential contribution a purchaser makes to the development and operation of a mineral property when it executes a take-or-pay contract. Thus, this Court observed recently in *Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Mississippi*, 474 U.S. 409 (1986):

> Take-or-pay provisions enable sellers to avoid fluctuations in cash flow and are therefore thought to encourage investment in well development. *Id.* at 412.

In addition, in *Universal Resources Corp. v. Panhandle Eastern Pipe Line Co.*, 813 F.2d 77 (5th Cir. 1987), the Court of Appeals for the Fifth Circuit analyzed take-or-pay contract clauses and recently found:

> *The purpose of the take-or-pay clause is to apportion the risks of natural gas production and sales between the buyer and seller.* The seller bears the risk of production. To compensate the seller for that risk, the buyer agrees to take, or pay for if not taken, a minimum quantity of gas. *The buyer bears the risk of market demand.* The take-or-pay clause insures that if the demand for gas goes down, seller will still receive the price for the Contract Quantity delivered each year. *Id.* at 80. (emphasis added).

The Fifth Circuit further expounded upon the nature of take-or-pay contracts in a later decision, observing that "the take-or-pay obligation ensures to the producer a continuous source of revenue to cover investment, operations, and maintenance." *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159, 1167 (5th Cir. 1988). Succinctly, the Fifth Circuit has noted that "[t]he take-or-pay option is commonly given in gas contracts because of the cyclical nature of the demand for gas." *PGC Pipeline v. Louisiana Intrastate Gas*, 791 F.2d 338, 341 (5th Cir. 1986).

Payments made under these take-or-pay contracts have created a question as to their proper tax treat-

ment. As evidenced by this case, the proper characterization of the interests created by the payments from OG & E to petitioners remains unresolved. The IRS has indicated its position in Rev. Rul. 80-48, 1980-1 C.B. 99 that these payments are taxable income to the producer. On the other hand, commentators generally agree that these payments warrant characterization as production payments under I.R.C. § 636 which are treated for federal income tax purposes as mortgage loans.[2] Given the magnitude of the issue and its recurrence throughout the natural gas industry, it is imperative that this issue be addressed. In the interest of the orderly and efficient administration of the tax laws, this issue needs to be finally settled. If this Court does not grant certiorari in this case, this issue is certain to be litigated in other circuits. It is quite likely that another circuit, presented with this identical issue, would reach a conclusion which would conflict with that of the Tenth Circuit below. Rather than awaiting that inevitable conflict, the magnitude of this issue to natural gas producers warrants its resolution by this Court at this time.

II. The Tenth Circuit's Conclusion That Section 636 Of The Internal Revenue Code Does Not Apply To Take-or-Pay Payments Contradicts Congressional Intent.

The extraction of minerals from their natural reservoir and their eventual exhaustion results in a physical depletion of the mineral deposit. This physical depletion of a mineral deposit necessarily reflects an

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[2] *See, e.g.*, Burke and Karpen, "New Revenue Ruling 80-48: A Blueprint for Recreating Carved-Out Production Payments?" 53 J. Tax'n 370 (1980); Linden, "Significant Current Developments in Oil and Gas Taxation," 38th Ann. Inst. on Oil & Gas L. & Taxation § 11.06 (1987).

economic depletion of its value.[3] In recognition of the depleting value of a mineral deposit, the Internal Revenue Code has since 1926 provided producers "a reasonable allowance for depletion" of "oil and gas wells [and] other natural deposits." I.R.C. § 611(a). For certain producers, this allowance is computed as a specified percentage "of the gross income from the property" (percentage depletion). I.R.C. § 613(a). "Gross income from the property" for oil and gas wells is defined as the "amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well." Treas. Reg. § 1.613-3(a) (1960). "Gross income from the property" for minerals other than oil and gas is defined as "gross income from mining." Treas. Reg. § 1.613-3(b) (1960). The allowance for percentage depletion under I.R.C. § 613(a), however, is limited to "50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion)." I.R.C. § 613(a). With respect to oil and gas wells, an additional limitation on percentage depletion of "65 percent of the taxpayer's taxable income for the year" was enacted in 1975. I.R.C. § 613A(d).[4]

In *C.I.R. v. P.G. Lake*, 356 U.S. 260 (1958), this Court held that a producer who sells a carved-out

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[3] Russell and Bowhay, *Income Taxation of Natural Resources*, Ch. 8.01, 1988 ed.

[4] I.R.C. § 613A was enacted by the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501(a), 89 Stat. 26 (1975). Under § 613A, percentage depletion on oil and gas wells is repealed for some producers on most wells. However, certain gas wells and producers are exempted from the repeal. I.R.C. §§ 613A(b) and (c). For those producers still entitled to percentage depletion, a new limitation based on the taxpayer's taxable income was added. I.R.C. § 613A(d).

production payment[5] receives "gross income from the property" for percentage depletion purposes. As a result of the decision in *P.G. Lake*, many taxpayers engaged in transactions designed to minimize the income limitations on percentage depletion. Producers would assign to a third party, in exchange for cash, the right to a share of the future production from a property, i.e., a carved-out production payment. By assigning the right to share in future production, a producer was then able to include the cash received in his "gross income from the property" for percentage depletion purposes pursuant to *P.G. Lake*, *supra*. Moreover, since the production, and therefore related expenses, had not yet occurred, the producers were able to increase their total percentage depletion deductions by increasing "taxable income from the property," thus minimizing the net income limitations of I.R.C. § 613(a), *supra*. Furthermore, by shifting the future income stream from sale of the production to the purchaser of the production payment, the producer was not liable for taxes on that income if and when production occurred.

In response to the use of carved-out production payments to minimize the limitations on percentage depletion, Congress enacted I.R.C. § 636 in 1969. Tax Reform Act of 1969, Pub. L. No. 91-172, § 503, 83

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[5] A production payment is the right to share in the production of a mineral in place, where such right is limited by a dollar amount, a quantum of mineral, or a period of time. Treas. Reg. § 1.636-3(a), Polevoi and Smith, *Federal Taxation of Oil and Gas Transactions*, § 9.07; Russell and Bowhay, *Income Taxation of Natural Resources*, Ch. 2.07, 1988 ed. A carved-out production payment is one purchased from a larger interest in the mineral deposit.

Stat. 487 (1969). The Committee reports clearly state that this was Congress' primary intention in enacting I.R.C. § 636:

> In the case of the carved-out payments, by the advancing of the time income (but not related expense) is reported for tax purposes, taxpayers have been able to avoid limitations based on net or taxable income—principally the 50-percent limitation on taxable income from the property for percentage depletion purposes. . .

S. Rep. No. 552, 91st Cong., 1st Sess. Pt. 1, at 183 (1969). Congress found that the payment of cash in exchange for a right to a share of future production was "similar, in fact, to a loan transaction with the loan secured by a mortgage on the property and the 'borrower' not personally liable for the loan." *General Explanation of the Tax Reform Act of 1969*, H.R. 13270, 91st Cong., 1st Sess. (1970) at 169. Therefore, under I.R.C. § 636 the seller of the production payment does not realize "gross income from the property", but instead is treated as receiving a mortgage loan which is repaid from production. I.R.C. § 636(a). "Thus, [under I.R.C. § 636], the use of a carved-out production payment would not cause income to be accelerated, and there would be, thus, no avoidance of the limitation on the percentage depletion deduction." S. Rep. No. 552 at 185, *supra*.

The relevant Committee reports make clear that Congress intended for I.R.C. § 636 to apply to transactions which are economically equivalent to loans where the lender is to be repaid from production, *supra*. Take-or-pay payments fall within this classi-

fication since the producer receives funds in return for his promise to repay the loan with production from the property. If producers could take these payments into "gross income from the property" in the year of receipt for percentage depletion purposes rather than in the year of production, they would "advanc[e] the time income (but not related expense) is reported for tax purposes,. . .[and will be] able to avoid limitations based on net or taxable income. . ." S. Rep. No. 552, *supra*, at 183.[6] This is precisely the tax result Congress intended to foreclose in enacting I.R.C. § 636. Under I.R.C. § 636, income from a take-or-pay payment should be recognized only as production occurs, thereby insuring that percentage depletion is correctly computed and is consistent with the economic reality of actual physical depletion of minerals.

In addition to possible effects on the percentage depletion limitation, Congress also sought at the time of enactment of I.R.C. § 636 to prevent the acceleration of income via carved-out production payments for other tax planning opportunities, such as ". . .the

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[6] At the time I.R.C. § 636 was enacted, an oil and gas producer was entitled to take percentage depletion on take-or-pay payments as well as payments for actual production during the year. However, the Tax Reform Act of 1986 added I.R.C. § 613A(d)(5), which now prevents oil and gas producers from taking percentage depletion on take-or-pay payments or any other payments made without regard to actual production. I.R.C. § 636 prescribes a similar linkage between income recognition and actual production.

It should be noted that I.R.C. § 636 applies to all mineral properties and the potential for avoiding percentage depletion limitations still exists for minerals other than oil and gas.

foreign tax credit limitation, the 5-year net operating loss carry-over limitation, and the 7-year investment credit carry-over." S. Rep. No. 552, *supra* at 183. The Tenth Circuit's decision, however, totally disregards Congress' express intent in enacting I.R.C. § 636, and judicially legislates an exception to its applicability which will allow taxpayers to once again accelerate recognition of income merely by conveying a share of future production.

Obviously, the judgment of the Tenth Circuit regarding the application of I.R.C. § 636 can not permissibly undermine Congress' intent in enacting that section. It is a basic axiom that a statute is to be construed in accordance with Congressional intent at the time of its enactment. *Louisiana Power & Light Co. v. United States Gas Pipe Line Co.*, 456 F.2d 326 (5th Cir. 1972), *rev'd on other grounds*, 453 U.S. 923 (1972); *see also, Alabama ex rel. Graddick v. Tennessee Valley Authority*, 636 F.2d 1061, 1066 (5th Cir. 1981), *cert. denied*, 454 U.S. 837 (1981). API therefore supports this Court's review and reversal of the decision below which fails to implement the will of Congress.

III. The Tenth Circuit's Test For Application Of Section 636 Of The Internal Revenue Code And The Regulations Of The Internal Revenue Service Thereunder Are Inconsistent, Resulting In Conflicting Sources Of Law.

The regulations promulgated pursuant to I.R.C. § 636 provide the following example of a typical "production payment" to illustrate the application of I.R.C. § 636:

> *Example (1).* On December 22, 1972, A, a cash-basis calendar-year taxpayer who owns operating mineral interest X, carves out of

> X a production payment in favor of B for $300,000 plus interest, payable out of 50 percent of the first oil produced and sold from X. In 1972, A treats the $300,000 received from B for the production payment as the proceeds of a mortgage loan on X. . . .

Treas. Reg. § 1.636-1(a)(3)(1973).

The interest created in Example 1 is economically indistinguishable from the interest created under a take-or-pay payment. In both situations, the producer has merely conveyed to the purchaser a right to future production. Neither purchaser has a formal, legal ownership interest in the minerals in place prior to their actual production. Both have made a cash payment to the producer in return for a future share of production. Both look to future production as their only means of recapturing their investment. Both have their share of future production limited by time, a quantum of mineral or an amount of money.

Since the two situations are economically equivalent, the application of I.R.C. § 636 should be consistently applied to each. In fact, the I.R.S. regulations stress the importance of economic realities in applying I.R.C. § 636:

> A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, *regardless of the language used to describe such right, the method of creation of such right or the form in which such right is cast.* (emphasis added).

Treas. Reg. § 1.636-3(a)(2) (1973).

Both the Tenth Circuit's analysis and conclusion below conflict with the analysis and result prescribed by the relevant regulations. Specifically, the analysis of the Tenth Circuit regarding the application of I.R.C. § 636 to take-or-pay payments would, if applied to the facts in Example 1 of the regulations, *supra*, render I.R.C. § 636 similarly inapplicable. Thus, the generic "production payment" illustrated in the regulatory example, which is economically equivalent to the take-or-pay payments in question, would not pass muster in the Tenth Circuit. The Tenth Circuit's ultra-restrictive analysis would render I.R.C. § 636 a nullity, *i.e.*, even the illustrative example of its operation contained in the regulations would no longer warrant its application. Moreover, the requirement of economic equivalency does not appear to have been considered, *supra*. This Court should clarify that, as between the law reflected in the regulations and the Tenth's Circuit's theory, the regulations reflect Congressional intent that I.R.C. § 636 be applied expansively to deny the accelerated recognition of income from mineral properties, *supra*.

Finally, in *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), this Court held that an agency's regulations "are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." 467 U.S. at 844. Despite its position in this case, the Internal Revenue Service is bound by its validly promulgated regulations under I.R.C. § 636, *United States v. Nixon*, 418 U.S. 683, 695-96 (1974), which, if applied in this case, would render that section applicable to take-or-pay payments, *supra*. To the extent those regulations

and the Tenth Circuit's analysis yield inconsistent results, this Court's guidance in *Chevron* should control:

> . . .[A] court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the. . .agency.

467 U.S. at 844.

API respectfully requests that this Court review this case to uphold the vitality of the Service's own regulations and I.R.C. § 636 itself.

CONCLUSION

The petition for a writ of certiorari should be granted in this case to provide needed guidance to taxpayers with respect to the proper tax treatment of billions of dollars of payments being received under take-or-pay purchase contracts similar to the one which is under consideration in this case.

Respectfully submitted,

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